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## THE JUSTIFIABILITY OF THE POLICY OF EXEMPTING FARMERS' MARKETING AND PURCHASING COOPERATIVE ORGANIZA- TIONS FROM FEDERAL INCOME TAXES

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FOR MANY years farmers' cooperative organizations meeting certain standards have been exempted from federal income taxes. This long standing immunity from taxation has, until recently, aroused little general public interest. The rising tax rates of the war period have increased the value of the exemption, and in some quarters the suggestion has been made that it should be repealed.<sup>1</sup> A reexamination of the policy underlying the exemption entails a consideration of the economic, as well as the legal, aspects of the farmers' cooperative movement<sup>2</sup> and a valuation of its accomplishments.

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He is the author of three series of "Studies in Federal Taxation," published in 1937, 1938, and 1940; of "Federal Estate and Gift Taxation," 1942; and is co-author of "Law of Federal Income Taxation," published in 1934.

<sup>1</sup>See, e. g., news article in the New York Herald Tribune, April 29, 1945, bearing the headline, "Co-operatives' tax advantage is debated in U. S. and Canada."

<sup>2</sup>No attempt will be made to consider the status of cooperative organizations, such as consumers' cooperatives or other types of cooperatives, which are outside the statutory exemption.

Section 101(12) of the Internal Revenue Code provides for the exemption from income tax of certain farmers' cooperative marketing and purchasing associations.<sup>3</sup> The exemption is strictly limited and narrowly circumscribed. It was inserted in substantially its present form in the Revenue Act of 1926. Even prior to the 1926 Act the Treasury Regulations had embodied comparable provisions interpreting, rather liberally, the less specific terms of the earlier Revenue Acts. Article 92, Regulations 33, promulgated under the Revenue Act of 1913, provided for the exemption of cooperative dairies meeting certain standards. Section II G (a) of the Revenue Act of 1913 merely exempted in general terms agricultural and horticultural associations. The Revenue Act of 1916, as amended by the Act of October 3, 1917, Section II (a), provided that farmers' and fruit growers' marketing associations operating as selling agents upon a non-profit basis were exempt from tax. Article 75, Regulations 33, promulgated under the amended statute, required that associations of this type show that they had no net income upon their own account and that the entire proceeds of sale, less selling expenses, were returned to the members upon the basis of the quantity of products furnished by them. Section 231 of the Revenue Act of 1918 contained the same provision as the 1916 Act, as amended. Article 522 of Regulations 45, promulgated under the 1918 Act, did not differ materially from Regulations 33, except that Regulations 45 made it somewhat clearer that cooperative associations acting as pur-

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<sup>3</sup>"Agricultural cooperation is a method of doing business. An agricultural cooperative association is a business organization—just as much so as any of the more familiar private enterprises. The fundamental characteristic of an agricultural cooperative is that it is operated for the mutual benefit of its members as producers—not as stockholders. Advantages which accrue to a member of a cooperative accrue primarily because of his patronage with the association and not because of any financial investment he may have made therein. The primary purpose of a cooperative is to return to his producer as much as possible for the products he sells; to provide him with the kind and quality of farm supplies that he desires, at the lowest possible cost . . . ." *A Statistical Handbook of Farmers' Cooperatives*, Farm Credit Administration, Bulletin No. 26 (1938), pp. 1, 2.

"An agricultural cooperative association is a business organization, usually incorporated, owned and controlled by member agricultural producers, which operates for the mutual benefit of its members or stockholders, as producers or patrons, on a cost basis after allowing for the expenses of operation and maintenance and any other authorized deductions for expansion and necessary reserves. . . . In a cooperative . . . the financial benefits accrue to the patrons, while in a commercial enterprise they accrue to those who have invested their money in the business." L. S. Hulbert, *Legal Phases of Cooperative Associations*, Farm Credit Administration, Bulletin No. 50 (1942), p. 1.

chasing agents were not exempt from income tax, but that rebates to their customers in proportion to their purchases were not includible in the association's income. Regulations 33 indicated somewhat less clearly a similar view.

The Revenue Act of 1921, Section 231(11), contained provisions similar to the 1918 Act, but in addition expressly provided that farmers' cooperative associations operating as purchasing agents of supplies and equipment for their members at cost plus expenses were exempt from income tax. Article 522, of Regulations 63, promulgated under the 1921 Act, somewhat liberalized the provisions of the earlier regulations by: (1) stating that the maintenance of certain reasonable reserves would not destroy the exemption, and (2) providing that cooperatives buying for their members could retain their exemption if they had capital stock which was limited in dividends to the legal rate of interest, and if all of this stock was owned by farmers. Section 231(11), of the Revenue Act of 1924, was the same as Section 231 (11) of the Revenue Act of 1921. Article 522 of Regulations 65, promulgated under the Revenue Act of 1924, contained provisions substantially similar to the statutory provisions enacted in the 1926 Act, which have persisted to the present time.

The 1926 Act liberalized the provisions contained in Regulations 65 and added limitations, but these changes were of a relatively minor character. The Report of the Senate Finance Committee upon the 1926 Act (Senate Report No. 52, 69th Congress, 1st Session, pp. 23, 24) makes it clear that the principal purpose of the provision was to insure the continued liberal administration of the exemption in the case of all truly cooperative purchasing and marketing associations.

It will be noted from this review of the law and regulations that farmers' non-profit *marketing* associations have been exempt from the income tax from almost the beginning of modern income tax history and that farmers' *purchasing* associations have been similarly exempted since the Revenue Act of 1921. Favorable legislative treatment of these organizations, corporate or otherwise, has not been limited to the taxing statutes. Farmers' marketing organizations were, for example, specifically stated by the Clayton Act<sup>4</sup> not to be unlawful organizations in restraint of trade under the anti-trust laws; the exemption was clarified and expanded by

<sup>4</sup>38 Stat. 730, 15 U. S. C. A. Sec. 12 (1914), 15 U. S. C. A. Sec. 17, 38 Stat. 731.

the Capper Volstead Act<sup>5</sup> to cover certain cooperatives which had capital stock; a special division was created in the Department of Agriculture by the Cooperative Marketing Act<sup>6</sup> to assist cooperatives; credit facilities for cooperatives through Banks for Cooperatives were provided by the Farm Credit Act<sup>7</sup> and its amendment in 1935; and the Motor Carrier Act<sup>8</sup> exempted vehicles operated by farmers' cooperatives from many of the provisions of that Act.

Practically every state has laws providing for the incorporation of agricultural cooperatives and many state statutes make special provision for the protection or encouragement of organizations of this type.<sup>9</sup> However, mere antiquity and continued practice do not always, or necessarily, furnish the correct answer to questions of social and economic policy. The premises upon which the policy was based may have been wrong originally or changing circumstances may have corroded any reality that underlay originally sound premises.

In exploring briefly the legal, economic, and social justification of the exemption of farm organizations from income taxes, it is necessary to give some consideration to: (1) the economic conditions which encouraged the foundation and growth of these organizations; and (2) the benefits realized by their members and society at large. It will also involve an attempt to evaluate: (3) the extent to which competing profit-making organizations are inequitably injured by the favored income tax position of farmers' cooperatives; and (4) the necessity or desirability of continued exemption. Finally, it is necessary to consider (5) the nature of the income received by cooperatives.

Any consideration of the policy underlying the exemption of cooperatives must explicitly or implicitly be based upon the fundamental premises that the national welfare demands a strong and prosperous agriculture. It is not supposed that any person would any longer dispute the proposition that the industrial and commercial interests of this country could not long remain in a healthy economic state if the agriculture upon which they are based were weak and decadent.<sup>10</sup> Full industrial employment can

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<sup>5</sup>42 Stat. 388, 7 U. S. C. A. Sec. 291 (1922).

<sup>6</sup>44 Stat. 802, 7 U. S. C. A. Sec. 451 (1926).

<sup>7</sup>48 Stat. 257, 12 U. S. C. A. Sec. 1131 (1933).

<sup>8</sup>49 Stat. 544, as amended, 54 Stat. 919, 49 U. S. C. A. Sec. 303 (1935) (1940).

<sup>9</sup>Ward W. Fetrow, *Three Principles of Agricultural Cooperation*, Farm Credit Administration Circular E 24, p. 8.

<sup>10</sup>For statements recognizing this fact see, e. g., H. R. Report No. 1816, 72nd Congress, 2d Session, Report on H. R. 13991 (1932) p. 7; Hearings

hardly be hoped for unless the purchasing power of the agricultural population can be maintained at high levels. This is such a self-evident truth that it is mentioned at this point only in order that the basic approach of the discussion following may be explicit and clear.

#### I. THE ECONOMIC CONDITIONS WHICH ENCOURAGED THE FOUNDATION AND GROWTH OF FARMERS' COOPERATIVE MARKETING AND PURCHASING ORGANIZATIONS

Farmers' cooperative *marketing* associations and farmers' cooperative *purchasing* associations must, for some purposes, be considered separately, even when these activities are conducted by a single cooperative, for the two types of organization have somewhat different objectives and origins, although their development is parallel. Cooperative marketing associations will first be considered.

##### A. *Cooperative Marketing Associations*

These associations grew out of the farmers' economic necessity to find an efficient method of marketing their crops which also would procure for them a fair price for their products. In about the middle of the nineteenth century, as farmers produced more and more for distant markets rather than for their own use and for sale in their immediate vicinity, they became further and further isolated from their markets. The problems of marketing became more complex and the need for car-lot shipments of uniform grades became necessary.<sup>11</sup> The individual farmer typically could not ship large quantities and had little knowledge of, or opportunities for learning, the current condition of the distant market.<sup>12</sup> If he produced more than one commodity, as most farmers did, his difficulties were increased. He was forced to rely upon a middleman for these services.

The farmer, forced to move his crop, had little bargaining power with the more centrally organized shipper, packer or other

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Before U. S. Senate Committee on Agriculture and Forestry, 72nd Congress, 2d Session Report on H. R. 13991 (1933) p. 373 (testimony of Rep. Hatton W. Summers, Texas); Senate Report No. 1251, 72nd Congress, 2d Session on H. R. 13991 (1933) p. 1; H. R. Report No. 6, 73rd Congress, 1st Session on H. R. 3835 (Agricultural Adjustment Act, 1933) p. 7; Hearings before the Committee on Agriculture, House of Representatives, 72nd Congress, 2d Session, Dec. 1932, p. 141.

<sup>11</sup>R. H. Elsworth, *Statistics of Farmers' Cooperative Business Organizations 1920-1935*, Farm Credit Administration, Bulletin No. 6 (1936) p. 3.

<sup>12</sup>W. B. Bizzell, *The Green Rising*, (Macmillan Co., 1926) p. 215.

distributor, and was forced to accept almost any arrangements the marketing agency made with or for for him.<sup>13</sup> The farmer had little choice. If he were to sell his crop at all, he was frequently faced with the necessity of accepting what the shipper or packer offered. If the goods were perishable, they could not be kept for a better bargain; if they were bulky, they could not be retained without storage facilities. The packer or shipper had storage and processing facilities not available to the farmers, and was in a position to make shipments in economical carload lots which the small farmer could not ordinarily do. In *Liberty Warehouse Co. v. Barley Tobacco Growers Cooperative Marketing Association*<sup>14</sup> the Supreme Court recognized that federal and state legislative assistance to farmers' cooperatives had its roots in the unequal bargaining position of the individual farmer. With conditions of this sort prevailing, many farmers came to the conclusion that they were receiving too little for their products, that in some instances the consumer was paying too much for them, and that the farmer was frequently receiving what he believed was too small a share of the consumer's dollar.<sup>15</sup>

Other causes for discontent with reliance upon uncontrolled marketing organizations interested in their own profit have given some impetus to the farmers' desire to solve their marketing problems in other ways. Private marketing agencies frequently had no standardized method of grading the agricultural products purchased by them, and the farmer could not be certain that he was

<sup>13</sup>Edwin G. Nourse, *The Legal Status of Agricultural Cooperation* (Macmillan Co., 1927) p. 30; *Northern Wisconsin Cooperative Tobacco Pool v. Bekkedal*, (1923) 182 Wis. 571, 197 N. W. 936; *Tobacco Growers' Cooperative Ass'n v. Jones*, (1923) 185 N. C. 265, 117 S. E. 174.

<sup>14</sup>(1928) 276 U. S. 71, 48 S. Ct. 291, 72 L. Ed. 473.

<sup>15</sup>*Manchester Dairy System, Inc. v. Hayward*, (1926) 82 N. H. 193, 132 Atl. 12. Grain marketing cooperatives came into existence, for example, mainly because elevator companies with a monopoly in the local market in many places quoted prices disproportionately low as compared with the prices paid at terminal markets. Nourse, op. cit. *supra*, p. 176. In the case of tobacco cooperatives they grew out of the situation in which the only buyers were a few large manufacturers who customarily bought supplies well in advance and who were under no necessity to bargain for any one crop at any particular time. Furthermore, tobacco must be graded by experts and many growers cannot tell the exact grade of their products. Ward W. Fetrow, *Cooperative Marketing of Agricultural Products*, Farm Credit Administration Bulletin No. 3 (1936), p. 79.

In more recent years fruit and vegetable growing has become the third most important source of farm cash income. It has been determined that in 1937 the consumer's dollar expended in chain stores for fresh fruit was divided as follows: 29.4c to the grower; distributors' margins 35.33c; retail margin 31.04c. M. C. Gay, *Marketing Fruits and Vegetables Cooperatively*, Farm Credit Administration Circular No. C-110 (1938), pp. 2, 33.

receiving the price which the quality of his product justified.<sup>16</sup> Furthermore, under existing arrangements there was no uniformity in the prices received by individual farmers for the same products. The shippers or packers, because of their relatively strong position, were frequently in a position to make unreasonably high charges for the services rendered by them in connection with the marketing operation.<sup>17</sup> In some situations the farmers were at the mercy of market speculators.

All of these difficulties and causes for dissatisfaction may be summarized by the observation that the farmer is an individual, a small business man, trying to do business with large and powerful interests in the market. This is not a situation peculiar to agriculture, but it is perhaps more exaggerated there than in other realms of business.<sup>18</sup> This type of problem is frequently solved by the organization of small units into large corporate units which will have more adequate bargaining power. It is common knowledge that this has been occurring to a greater and greater extent.<sup>19</sup> It was apparent that no one farmer could do very much to improve his situation. It was equally apparent that if agriculture was to remain an attractive source of livelihood to individual farmers, and not a perennially depressed industry, these conditions must be alleviated. Combinations for the purpose of cooperative marketing

<sup>16</sup>Fetrow, (Bulletin 3) *supra*, p. 13.

<sup>17</sup>Fetrow, op. cit. *supra*, p. 17.

<sup>18</sup>According to Dr. A. L. Meyers of the U. S. Department of Agriculture, the farm economy is practically the only portion of our economy which is still operating under conditions of pure competition while there are varying degrees of monopoly in marketing operations. Final Report and Recommendations of the Temporary National Economic Committee; Investigation of the Concentration of Economic Power, Senate No. 35, 77th Congress, 1st Session (1941), p. 387. See also, Albert L. Meyers, Agriculture and the National Economy, Monograph No. 23, Temporary National Economic Committee, Investigation of Concentration of Economic Power (1940), p. 9.

<sup>19</sup>Improved mechanical processes have, of course, assisted in this tendency. The increased centralization of agriculture and the consequent trend away from the traditional pattern of one-family farms is indicated to some extent, in the following figures:

	1910	1920	1930	1940
Number of farms	6,361,502	6,448,343	6,288,648	6,096,799
Land being farmed, (thousands of acres)	878,798	955,884	986,771	1,060,852

(Agricultural Statistics 1942, U. S. Dept. of Agriculture, p. 614). It will be noted that between 1920 and 1940 the number of farms decreased by 351,544, while the land under cultivation increased by 104,968,000 acres. The per cent of all farm lands in farms over 1,000 acres increased from 19 per cent in 1910 to 29.4 per cent in 1935. Meyers, op. cit. *supra*, p. 10. Increased efficiency and the development of machinery for use on smaller farms has allowed the size of the one-family farm to be expanded to some extent. This does not, however, account for the total increase of the large farms.



impressed many farmers as an economical and efficient<sup>20</sup> method of converting the many small units in the industry into an economic organization commensurate with the organization of the market in which the farmers sold their products.<sup>21</sup>

### B. Cooperative Purchasing Associations

A substantial number of cooperative marketing associations also purchase supplies and equipment for their patrons; other cooperatives only purchase supplies and equipment.<sup>22</sup> The purchasing function has developed along with the marketing function and grew out of a situation which appears to be peculiar to the agricultural industry. Prior to the institution of group buying farmers, particularly small farmers, purchased their supplies and equipment at *retail* prices, but sold their product at *wholesale* prices. Very few farmers had enough bargaining power, or the quantity needs, to require the sale to them of feed, fertilizer, seeds, and such items, at wholesale prices.<sup>23</sup> This situation naturally resulted in lower profits to farmers and was particularly oppressive in view of the relatively small cash income of farmers.<sup>24</sup> Furthermore, farmers found that commercial suppliers frequently provided unsatisfactory products at very high prices. Seeds were sometimes not well adapted to their purposes;<sup>25</sup> fertilizers were occasionally adulterated and unsatisfactory. The private suppliers failed to make the efforts to improve the defects which many agriculturists thought should be made. In fact, some purchasing cooperatives were initiated principally for the purpose of guaranteeing dependable supplies.<sup>26</sup>

It is apparent that there was an economic necessity that the

<sup>20</sup>Nourse, op. cit. *supra*, p. 14.

<sup>21</sup>Nourse, op. cit. *supra*, p. 157.

<sup>22</sup>Encyclopedia Americana 643.

<sup>23</sup>Joseph G. Knapp and John H. Lister, Cooperative Purchasing of Farm Supplies, Farm Credit Administration, Bulletin No. 1 (1935), p. 2.

<sup>24</sup>The average cash income per farm, as found by the Department of Agriculture, was as follows: (Agricultural Statistics 1942, p. 660):

1930 .....	\$1,434	1934 .....	\$1,001	1938 .....	\$1,292
1931 .....	997	1935 .....	1,124	1939 .....	1,398
1932 .....	726	1936 .....	1,303	1940 .....	1,500
1933 .....	810	1937 .....	1,427	1941 .....	1,940

(From 1933 on this figure includes government benefit payments. It will be apparent that if these are the averages, many farm incomes are much lower.)

<sup>25</sup>Knapp and Lister, op. cit. *supra*, p. 45.

<sup>26</sup>For example, there are certain associations which supply seeds of known quality to cotton growers. R. H. Elsworth, Statistics of Farmers' Cooperatives, Farm Credit Administration, Bulletin No. 6, (1936) p. 27.

farmer-producer take steps to correct the situation in which he found himself as farming became a business of buying and selling in the market rather than a relatively self-sufficient domestic economy. As in the case of marketing, the farmer sought to overcome the handicap of buying as a small decentralized business by cooperating with others who were in the same position.

### C. *The Organization of Marketing and Purchasing Cooperatives*

The forms of these organizations were at first informal, and a long period of experimentation was necessary before a generally satisfactory working pattern emerged. While the experiment is still continuing, it is possible to generalize to some extent concerning the fundamental lines upon which most farmers' marketing and purchasing cooperatives are presently organized. It is unnecessary for purposes of this article to consider the many divergencies in detail which may appear in individual organizations. In general, agricultural cooperatives follow the Rochdale<sup>27</sup> principles. Only one vote per member is allowed, irrespective of how many shares of stock are owned by each individual;<sup>28</sup> returns upon capital borrowed by or invested in the cooperative organization or corporation are limited; and the savings resulting from the cooperative sale or purchase of commodities are distributed to the patrons of the cooperative in proportion to their patronage.<sup>29</sup> This form of organization is by now so well recognized that any marked deviation from the pattern would probably mean that the deviating organizations would not be regarded as true cooperatives.

## II. THE EXTENT TO WHICH FARMERS' COOPERATIVES HAVE BENEFITED THEIR MEMBERS AND OTHERS

By and large it seems to be correct to say that the farmers' cooperatives have succeeded reasonably well, in the rather limited area in which they have so far operated, in achieving their objectives. They have also indirectly benefited non-members, and have contributed to the progress toward a strong agricultural industry. In the field of marketing the cooperatives have, in many areas, succeeded in reducing the cost of the marketing operation by efficient management, and by eliminating the costs of duplication

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<sup>27</sup>The Rochdale cooperative movement started in England in 1844. 4 Encyclopedia of the Social Sciences, p. 285, "Consumers Cooperation."

<sup>28</sup>Occasionally additional votes based upon the amount of patronage are given.

<sup>29</sup>Ward Fetrow; (Bulletin 3) *supra*, pp. 2-8; L. S. Hulbert, op. cit. *supra*, pp. 2, 3.

in equipment, solicitation and promotional activities present where agencies market for profit. The reduction in these costs benefits both the farmer<sup>30</sup> and the consumer. The cooperatives have done much to improve standardization and grading of produce,<sup>31</sup> they have tended to break down local monopolies of private marketing agencies, thus insuring the end that farmers get a fairer share of the ultimate market price. They have tended to stabilize marketing by relieving the farmer of the necessity for selling his whole crop at harvest time at a low price and by distributing produce between the markets in such a way as to prevent a glut in one while another starved.<sup>32</sup> In a number of instances they have succeeded in reducing the spread between prices at the shipping point and at the terminal market.<sup>33</sup>

In reviewing the judicial findings concerning agricultural cooperatives since the end of the last war, Nourse, a recognized authority, found<sup>34</sup> the prevailing judicial opinion to be that such organizations have not been injurious either to consumers or other classes in the community. In his opinion they have not impeded competition, but have increased it; they have helped protect the farmer against the monopolistic position of the middleman or manufacturer; they have protected many small producers from ruinous competition with each other; they have tended to improve technical processes and financial practices; and they have contributed to the stabilization not only of agriculture, but also of the whole economic existence of the community in agricultural areas. To the extent that they have achieved these ends, the farmers' co-

<sup>30</sup>Nourse, *op. cit. supra*, p. 15. It is to the farmers' interest that products be moved to the consumer as efficiently as possible with the smallest possible charges for processing and distribution. Dr. F. V. Waugh, U. S. Department of Agriculture, Final Report and Recommendations of the T. N. E. C., *supra*, p. 386.

<sup>31</sup>Nourse, *op. cit. supra*, pp. 17, 424. Cooperative Creamery Associations have made an important contribution to the grading and production of high quality butter. Fetrow, Bulletin No. 3, *supra*, pp. 25, 27. They have assisted in the development of standard grades of livestock (Fetrow, (Bulletin No. 3) *supra*, p. 64), and turkeys (Fetrow, (Bulletin No. 3) *supra*, p. 78). In the case of wool, prior to the entry of cooperatives into the field, private dealers ordinarily bought wool for a flat price making no allowances for the quality or condition of the wool. The cooperatives have done much to cause the abandonment of this practice by their activities of grading large lots of wool and selling according to grade. (Fetrow, (Bulletin No. 3), *supra*, p. 97).

<sup>32</sup>The cooperative often provides the storage facilities and the financing which makes this possible. Nourse, *op. cit. supra*, p. 163. See also Fetrow, Bulletin No. 3 *supra*, pp. 64, 78, 98.

<sup>33</sup>Fetrow, (Bulletin No. 3) *op. cit. supra*, p. 59; L. S. Hulbert, *supra* p. 8.

<sup>34</sup>Nourse, *op. cit. supra*, p. 418.

operatives have acted in accordance with and served a national public policy of long standing.<sup>35</sup>

The purchasing activities of farmers cooperatives, in those areas where they have been active, have been successful in achieving savings for their patrons. In addition their competition has forced others to sell at lower prices.<sup>36</sup> They have eliminated from the price the farmer pays competitive selling expenses, the cost of credit extension, and the risks<sup>37</sup> involved in credit transactions. They have made services available and have procured high quality goods which the farmer could not otherwise have attained.<sup>38</sup> Some purchasing cooperatives operate laboratories to test the quality of available goods and to find methods of improvement.<sup>39</sup> It is therefore fair to say that purchasing cooperatives have substantially benefited farmers,<sup>40</sup> and that they have made a real contribution toward a prosperous and efficient agriculture.

### III. POSSIBLE INJURY TO COMPETING PROFIT-MAKING MARKETING AND SELLING AGENCIES

It is probably true, as suggested by opponents of the cooperatives, that the advantages given to farmers' marketing or purchasing cooperatives both by the state and federal legislatures have assisted them to some extent in their competition with profit-making agencies. Recently great emphasis has been laid by some upon the alleged injustice done to profit-making agencies by the exemption from federal income tax accorded to cooperatives. The validity of this contention may be considered from two points of

<sup>35</sup>"Public policy has generally attempted to eradicate various monopolistic abuses and practices, or, if this is not feasible, that other methods of control be instituted. The basic requirement is that competitive situations in the Nation's markets for commodities . . . be maintained, and where they do not exist, that competitive situations be brought about . . ." Temporary National Economic Committee, 76th Congress, 3rd Session, Investigation of Concentration of Economic Power, Monograph No. 4, Concentration and Composition of Individual Incomes, 1918-1937, p. 5.

<sup>36</sup>Knapp & Lister, op. cit., *supra*, p. 44.

<sup>37</sup>Cooperatives frequently sell for cash only.

<sup>38</sup>Knapp & Lister, op. cit. *supra*, pp. 6-7.

<sup>39</sup>Knapp & Lister, op. cit. *supra*, p. 46.

<sup>40</sup>In 1936, 4,010 cooperative associations returned patronage dividends of \$25,380,000 to their patrons. Approximately 37 per cent of all marketing and purchasing associations paid patronage dividends in that year. In addition, part of the savings effected by cooperatives was retained to build up the farmers' investment in them, in the amount of \$13,306,000. In addition, many cooperatives increased farmers' incomes by enabling them to secure higher farm prices or lower prices for supplies in an unknown amount. A Statistical Handbook of Farmers' Cooperatives, Farm Credit Administration, Bulletin No. 26 (1938), pp. 6, 7.

view: (A) the extent of this exemption; and (B) the probable extent of its competitive benefit.

### A. *The Extent of the Exemption*

The exemption accorded to certain cooperatives under the federal Revenue Acts is not as broad as is sometimes assumed. It applies only to farmers' associations organized and operated upon a cooperative basis, which (a) market the products of members or other producers and return to them the proceeds of sales less necessary marketing expenses on the basis of the quantity or value of the products furnished, or (b) purchase supplies and equipment for their members or others at cost plus necessary expenses.

With respect to the marketing associations, it is clear from the statute and regulations<sup>41</sup> that if the proceeds are not returned to the producers, member and non-member alike, in proportion to the produce marketed by them, no exemption is allowable. The members are not allowed to make a profit out of the non-members.<sup>42</sup> The statute specifically provides that the exemption shall be lost if the association markets more products for non-members than it does for members. These provisions place a very definite deterrent upon attempts of cooperatives to increase their business in the field of non-members.<sup>43</sup>

The ability of purchasing cooperatives to expand their business without persuading their patrons to become members and share in the responsibilities of the organization is even more limited. Under the statute purchasing cooperatives lose their exemption if more than 15 per cent of their purchases are for persons who are not either members or producers.

The variety of methods of financing other than borrowing available to cooperatives which wish to retain tax exemption is extremely limited. If they wish to raise capital by the sale of stock, substantially all the voting stock must be held by farmers,

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<sup>41</sup>Sec. 29.101 (12)-1 of Regulations 111.

<sup>42</sup>*Fruit Growers' Supply Co. v. Commissioner*, (C.C.A. 9th Cir., 1932) 56 F. (2d) 90. In this case the court pointed out that non-members were charged the full market price; that no patronage dividends were returned to them; and that there was, therefore, profit to the corporation from sales to non-members, which was taxable to it irrespective of whether the corporation subsequently returned this profit to its members in some form or another.

<sup>43</sup>Of course, if the non-members can be persuaded to become members and share in the responsibilities of the enterprise, the cooperatives' business is increased at the expense of that of profit making competitors.

and dividend rates must be limited to no more than eight per cent or the legal rate of interest in the state of incorporation, whichever is higher. Non-voting preferred stock with fixed dividends may be sold to non-farmers. These provisions, which were inserted to insure that the exemption was made only when the cooperatives are controlled by farmers, also have the effect of limiting the ability of cooperatives to raise capital. The statute and the regulations allow cooperatives otherwise meeting the requirements laid down to accumulate reasonable reserves for necessary purposes.

*B. The Probable Extent of the Competitive Benefits from the Exemption*

The exemption is extended not to all cooperatives, but only to those which meet the limitations set by the statute. Without at this time going into the question whether true cooperatives coming within these limitations have taxable income and the amount of any taxable income they may have,<sup>44</sup> the extent of the competitive benefit to cooperatives from tax exemption will be considered.

The cooperatives sell their members' products in the same market as do the private selling agencies and for about the same prices. The fact that the marketing cooperative may have reached the market with lower costs than the private agency may give it a competitive advantage,<sup>45</sup> but this advantage is not attributable to the fact that the cooperative is not required to pay a tax upon any profit it may realize. Similarly, the purchasing cooperative cannot obtain merchandise at lower prices than do ordinary retailers merely because the cooperative need pay no income tax upon the profit realized upon resale. If the purchasing cooperative is more efficient than the private retailer and makes greater profits, the greater profits are not attributable to the fact that the cooperative will pay no income tax.<sup>46</sup> Income taxes subsequently payable upon profits realized do not determine the amount of profit. Tax exemption has, therefore, no direct bearing upon any competitive advantage which the cooperatives may have in their buying and selling operations.

It is sometimes argued that the exemption places cooperatives

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<sup>44</sup>This will be considered below, see Section V.

<sup>45</sup>Cooperatives would not ordinarily sell for less than the market price thus reducing their return to producers, for they are controlled by the producers, who would be quick to reverse any such policy.

<sup>46</sup>Chain stores, because of economy in operation, sometimes make larger profits than individual retailers without the benefit of tax exemption.

in a position to build up large reserves which may be employed to purchase the facilities of private business or to build additional competing facilities which are detrimental to private agencies in the field. While it is highly probable that the farmers' cooperatives' exemption from corporate income tax assists them in building up their capital, there appears to be a tendency to overemphasize this aspect of the matter. This attitude overlooks the limitation found in Section 101 of the Internal Revenue Code that the reserves may only be reasonable and for necessary purposes. It also assumes a much greater economic power in cooperatives throughout the country than the facts warrant.<sup>47</sup> And, thirdly, this argument assumes that farmers who have created the cooperatives for the express purpose of augmenting their own incomes will allow cooperatives to retain the savings made for them for a long period of time in order to build up an enormous capital plant or that farmers would continue to support organizations which failed to benefit them.<sup>48</sup> This assumption is contrary to all experience. The typical farmer is not ordinarily a rich man who can afford to invest any very substantial portion of his income in capital goods.<sup>49</sup>

There has been some tendency to exaggerate the economic strength of cooperatives, particularly in the marketing field.<sup>50</sup> Part

<sup>47</sup>See discussion below, p. 357 et seq.

<sup>48</sup>The only methods by which farmers' cooperatives may obtain capital as a practical matter are borrowing and investment by farmers. Farmers ordinarily cannot make a large investment at any one time. In order to build up necessary capital for physical facilities and operating reserves, it is the common practice for farmers to authorize the cooperative to retain, for a period of time or indefinitely, a portion of the patronage dividends otherwise payable to them. Thus capital is built up gradually out of relatively small contributions.

<sup>49</sup>See farm income figures above.

<sup>50</sup>In 1938 it was stated: "The fact seems evident that many of the cooperatives of today are operating on a volume which is too small for maximum efficiency." A Statistical Handbook of Farmers' Cooperatives, Farm Credit Administration, (1938), p. 11. The consolidated assets of all farmers' associations are shown as follows (p. 155):

Cash	Re- ceiv- ables	Inven- tory (Thousands of dollars)	Land build- ings & equip- ment	Other	Total
53,825	86,739	115,714	179,300	75,268	510,846

(No more recent official figures appear to be available)

In the year 1936 one processor and distributor of food products alone (General Foods Corporation) had assets of \$74,195,622; in 1938 of \$89,020,025; in 1940 of \$97,304,035; and in 1942 of \$123,028,062. Moody's Manual of Investments (1943), p. 2698.

of this exaggeration may be attributable to an over-generalized view of the situation and to a lack of understanding of the fact that most cooperatives undertake only one or two steps of the whole marketing process of getting goods from producer to consumer. For example, some cooperatives are merely associations which bargain with commercial buyers to fix prices and grades.<sup>51</sup> Other associations assemble products at a local point into carload lots and ship them to a central market where they are handled by agencies operating in the market.<sup>52</sup> Some associations operate in the terminal markets themselves as selling agents either for local cooperatives or individuals.<sup>53</sup> Some cooperatives maintain warehouses, packing or processing facilities, and others do not.<sup>54</sup>

In view of the great diversity in the services performed by cooperatives, it is extremely difficult to make any accurate generalizations concerning their part in the process of marketing. Thus, while it may be said that in the crop year 1935-36 cotton marketing cooperatives "handled" 12.5 per cent of all cotton ginned,<sup>55</sup> this suggests a much greater operation upon the part of the cotton cooperatives than is the fact. The marketing of cotton involves the hauling of cotton to the gin, the ginning of cotton (which is paid for by the farmers), the baling of the ginned cotton, the warehousing of the cotton where it is stored pending sale. Upon sale it is delivered to textile mills. At this point it is, of course, still far from the ultimate consumer. The part of this whole process which is ordinarily carried on by the cotton cooperatives is the sale of the ginned cotton directly to mills or to others.<sup>56</sup> They rarely maintain their own warehouses, but store the cotton in privately-owned warehouses.<sup>57</sup> In other words, the cooperatives merely acted as factors for a very small percentage of the cotton

<sup>51</sup>Beet sugar and fluid milk cooperatives frequently operate in this manner. Elsworth, *op. cit. supra*, p. 6.

<sup>52</sup>Elsworth, *op. cit. supra*, p. 3. In 1936, Elsworth states, nine-tenths of the active farmers' marketing associations were of this local variety. These local associations sometimes federate into state or regional groups. In the fresh fruit and vegetable field many of the cooperatives are little more than assembling agencies for commission houses. Gay, *op. cit. supra*, p. 27.

<sup>53</sup>Elsworth, *op. cit. supra*, pp. 4, 5.

<sup>54</sup>Elsworth, *op. cit. supra*, p. 6.

<sup>55</sup>Elsworth, *op. cit. supra*, p. 23.

<sup>56</sup>Fetrow, (Bulletin 3) *supra*, p. 7.

<sup>57</sup>There are a number of cooperative cotton gins. Fetrow, *op. cit. supra*, p. 9.



sold in the crop season 1935-36,<sup>58</sup> and, with the exception of a certain amount of cotton ginning,<sup>59</sup> this was their sole activity in the whole complicated process of moving cotton from the farm to the textile mill.

From the early 1930's the most important cooperative marketing activity has been in the field of dairy products.<sup>60</sup> In the year 1934, 8,463,454,240 pounds of milk were sold under arrangements made by cooperative *bargaining* associations.<sup>61</sup> It will be noted again what a small part the cooperative activity took in the whole marketing process. In 1934, 35.7 per cent of the creamery butter *manufactured* in the United States was *manufactured* cooperatively,<sup>62</sup> but in the same year only 9.7 per cent of the cream-

<sup>58</sup>In more recent years, the comparable figures are as follows:

PERCENT OF TOTAL COTTON CROP  
HANDLED BY LARGE-SCALE COTTON  
COOPERATIVE ASSOCIATIONS

Season	Total Cotton Ginned	Cotton Handled by Coop. Assns.	Per cent of Total Ginned
1936-37	12,141,376	1,822,899	15.0
1937-38	18,252,075	2,132,255	11.7
1938-39	11,623,221	1,426,005	12.3
1939-40	11,481,300	963,569	8.4
1940-41	12,297,970 <sup>1</sup>	891,973 <sup>1</sup>	7.3
1941-42	10,494,881 <sup>1</sup>	1,000,704 <sup>1</sup>	9.5
1942-43	12,438,033 <sup>1</sup>	1,476,220 <sup>1</sup>	11.9
	99,149,202	11,192,723	11.3

<sup>1</sup>Preliminary

These figures were furnished by the United States Department of Agriculture.

<sup>59</sup>There were approximately 240 cooperative ginning associations operating in 1935. Elsworth, op. cit. *supra*, p. 27.

<sup>60</sup>Elsworth, op. cit. *supra*, p. 13; Wanstall and Elsworth, Statistics of Farmers' Marketing and Purchasing Cooperatives, 1942-43 Marketing Season, Farm Credit Administration, Miscellaneous Report No. 70 (1944), p. 8.

<sup>61</sup>Something more than half that amount was handled by milk associations distributing at wholesale or retail. Elsworth, op. cit. *supra*, p. 41. In 1936 there were 105,236 million pounds of milk produced in the United States. Agricultural Statistics 1943, p. 320. In 1935 the value of all dairy products sold at wholesale and retail is estimated to have been \$1,601,215,000. Of this the following companies distributed the amounts indicated:

National Dairy Products Corp. ....	\$290,441,000
Beatrice Creamery Co. ....	57,117,000
The Bordon Company ....	229,888,000
Fairmount Creamery Co. (Del.) ....	42,995,000
	<hr/>
	\$620,441,000

A. C. Hoffman, Large-Scale Organizations in the Food Industries, Monograph No. 35, Investigation of Concentration of Economic Power, T.N.E.C. (1940), p. 27.

<sup>62</sup>Elsworth, op. cit. *supra*, p. 34.

ery butter manufactured in the United States was *marketed* cooperatively.<sup>63</sup> Again it is apparent that even in this important field of cooperative activity the cooperatives have taken a relatively small part in the whole operation of placing farm products in the consumers' hands.

It hardly seems necessary to go into detail as to each commodity which at some point in its passage from farmer to consumer may be touched by cooperative activity. The foregoing should be adequate to demonstrate that marketing cooperatives generally are far from being sufficiently strong either to build up enormous reserves to buy their competitors or drive them out of the market or to create for themselves anything like a monopoly in the marketing of any product.<sup>64</sup>

In a study published in 1938 the Department of Agriculture found that approximately 2,538 associations were primarily engaged in purchasing and 73 per cent of the 7,500 marketing associations perform other services, including some purchasing.<sup>65</sup> Most of these associations purchase for their members only certain, or a limited number of, commodities. Some buy only feed, others seed and fertilizer, others all three commodities. By far the greatest number of these associations did a gross business of less than \$100,000 per year and only four of more than a million.<sup>66</sup> The total gross amount of supplies purchased for farmers by all associations was \$313,494,000, of which the largest single items were feed and petroleum products.<sup>67</sup> In 1936 (the year principally covered by this study) 69,263 corporate<sup>68</sup> retail and wholesale establishments filed income tax returns showing net income of

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<sup>63</sup>Elsworth, op. cit. *supra*, p. 38.

<sup>64</sup>At one time some persons professed to fear that these marketing organizations might gain monopolistic control over one or more commodities which would allow them to fix prices to the purchaser. The history of their operations, and the fact that they cannot control production in a field in which new producers can easily enter if prices are attractive, appear to have quieted this fear to a degree. In truth, any general tendency toward effective monopolistic price control seems to be rather remote. The Secretary of Agriculture is given authority to prevent monopolistic action resulting in enhanced prices in the event that cooperatives abuse their position (7 U.S.C. §291) and in any event monopolistic practices would be subject to the action of the anti-trust laws if they developed. *U. S. v. Borden Co.*, 308 U. S. 188 (1939).

<sup>65</sup>A Statistical Handbook of Farmers' Cooperatives, *supra*, p. 6.

<sup>66</sup>A Statistical Handbook of Farmers' Cooperatives, *supra*, p. 89.

<sup>67</sup>A Statistical Handbook of Farmers' Cooperatives, *supra*, p. 91.

<sup>68</sup>This does not include merchants doing business other than in corporate form.

\$1,136,419,000 and an additional 76,257 filed returns showing no net income or a deficit.<sup>69</sup>

In the crop year 1942-1943 it is estimated that 2,742 cooperatives were primarily engaged in purchasing supplies<sup>70</sup> and that these did a *gross* business of approximately \$600,000,000 in that year.<sup>71</sup> In the crop year 1939-1940 the comparable figures were 2,649 cooperatives doing a gross business of \$358,000,000.<sup>72</sup> In 1940, 71,766 corporate retail and wholesale establishments filed income tax returns showing a net income of \$1,270,122,000 and gross receipts of \$40,022,103,000; 68,083 establishments filed returns showing no net income or a deficit and gross receipts of \$7,193,940,000.<sup>73</sup>

It is apparent that the number of cooperative purchasing establishments is very small compared to the number of corporate merchandising establishments.<sup>74</sup> In 1940, 2,675 filling stations operating under the corporate form showed gross receipts of \$317,990,000,<sup>75</sup> more than the gross receipts of farmers' cooperatives for all commodities in 1936, and more than half of the gross business of all farmers' cooperatives in the crop year 1942-1943.

In summary, it is concluded that exemption of cooperatives from income tax is very limited; that it gives the cooperatives no direct competitive advantage in buying and selling operations; but that it does assist to some extent in enabling cooperatives to build up capital and operating reserves.<sup>76</sup> This assistance is insufficient to permit the cooperatives to achieve a commanding position in the marketing or purchasing process as a whole. The conclusion that there is or could be a competitive advantage from tax exemption, regardless of whether it is as great as is sometimes supposed, necessitates a consideration of whether or not this advantage is justifiable.

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<sup>69</sup>Statistical Abstract of the United States, 1943, U. S. Department of Commerce, Bureau of the Census, p. 263.

<sup>70</sup>Wanstall and Elsworth, Statistics of Farmers' Marketing and Purchasing Cooperatives, 1942-43 Marketing Season, Farm Credit Administration Miscellaneous Report No. 70, p. 1.

<sup>71</sup>Wanstall and Elsworth, *supra*, p. 3.

<sup>72</sup>In the crop year 1940-41 the marketing organizations did a gross business of \$1,911,000,000, and in the year 1942-43 of \$3,180,000,000. Wanstall and Elsworth, *supra*, pp. 1, 3.

<sup>73</sup>Statistical Abstract of the United States, 1943, p. 267.

<sup>74</sup>If individual proprietorships and partnerships were included, the disparity would, of course, be much greater.

<sup>75</sup>Derived from Statistical Abstract of the United States, 1943, p. 267.

<sup>76</sup>As to the taxability of the retained amounts to the members, see Section V below.

## IV. THE JUSTIFIABILITY OF THE TAX EXEMPTION

Exemption from income tax has been traditionally granted to forms of organizations which make an important contribution to the well-being of society and which do not operate for the purpose of making a profit for themselves. Thus, to mention a few, schools, churches, charitable and scientific organizations, and athletic and social clubs, have been given the advantage of tax exemption.<sup>77</sup> The benefit to society from the existence of such institutions has been recognized in this manner even though in many instances the organizations have income which would be taxable in the hands of others and even though they may, to some extent, compete with private owners. For example, certain large universities own a great deal of city real estate upon which are erected apartments and business buildings. The universities are in competition with private real estate operators, but that fact has not been thought to be an adequate reason for removing the support and assistance afforded to the universities through income tax exemption.<sup>78</sup> There appears to be no disposition to alter the underlying policy that such organizations, if they are not operated for their own profit in the ordinary business sense,<sup>79</sup> should not be subject to income tax. A proposal by the Treasury Department, in connection with the Revenue Act of 1942, that the business income of educational and other organizations be subjected to income tax was summarily rejected by Congress.<sup>80</sup> If the basic policy is to

<sup>77</sup>Section 101 of the Internal Revenue Code.

<sup>78</sup>It is well known that Trinity Church in New York, for example, owns much business and other property in New York, which is in competition with private owners. The really important competitive advantage held by schools, churches, and public hospitals, is an exemption from local real estate and other property taxes in many localities. This allows them to own and operate real estate much more profitably than private owners. Co-operative organizations, however, pay these taxes upon property and other similar local taxes.

<sup>79</sup>And by that it is meant that the purpose of the organization is not for profit to itself, for many charitable and scientific organizations do have profits or economically benefit their patrons. For example, a Y. M. C. A. may provide pleasant sleeping quarters and athletic facilities at lower than commercial rates, and these are available to all who wish to join, irrespective of whether the members have sufficient means to pay the commercial rates. The lower cost results in savings to members for services in much the same way as do cooperatives. If the facilities are well patronized they may show a profit. They are in direct competition with hotels, private gymnasiums, etc.

<sup>80</sup>Hearings Before the Committee on Ways and Means, House of Representatives, 77th Congress, 2d Session on Revenue Revision of 1942, Vol. 1, p. 89. It might be pointed out that the furtherance of economic or social policies which are thought by Congress to be desirable through tax benefits is not limited to organizations of that sort. Two examples might be cited: the great advantages (see Hearings Before the Committee on Ways and

remain—and apparently it is—the sole question is: Do the cooperatives fill such a social and economic need that the exemption is warranted upon that ground?

The economic conditions leading to the formation of cooperative selling and purchasing groups have been discussed. An attempt was made in this discussion to show that by virtue of the traditional organizational form of agriculture, the independent small farm, the farmer was at a great bargaining disadvantage and was frequently forced to accept low prices for his products and pay high prices for what he purchased.<sup>81</sup> It has for a long time been recognized that if the traditional pattern of small family farms was to continue, and if the farmer's purchasing power was to be increased<sup>82</sup> or even maintained, methods would have to be developed which would increase the bargaining strength and efficiency of the individual farmer.<sup>83</sup> The cooperative movement seemed to offer a possible method of providing assistance in this direction and consequently state and federal legislatures gave it some encouragement.

It has been said by sincere and well-meaning people that it may have been desirable to give the cooperatives advantages in their initial stages, but that this policy should not be continued

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Means, House of Representatives, 77th Congress, 2d Session on Revenue Revision of 1942, Vol. III, p. 2988) of percentage depletion is accorded oil and other mining companies because Congress was of the view that this tax incentive was necessary to encourage exploration and development of certain mineral resources; and the allowance of the deduction by employers of contributions to pension trusts was granted to encourage employers to look to the welfare of their employees (see Hearings Before the Committee on Ways and Means, House of Representatives, 77th Congress, 2d Session, on Revenue Revision of 1942, Vol. III, p. 2405).

<sup>81</sup>At various times in history other factors, such as the tariff upon manufactured articles, the lack of industrial purchasing power, and the loss of foreign markets, have contributed to and exaggerated this situation. See, e. g., Hearings Before the Committee on Agriculture and Forestry, U. S. Senate, 72nd Congress, 2d Session on H. R. 13991, pp. 349, 350. With these factors there is not now any immediate concern, but the situation would exist irrespective of these factors, although perhaps in a less aggravated form.

<sup>82</sup>In 1937 farmers constituted 24.6 per cent of the total population and agricultural income represented only 8.9 per cent of the total national income. This is not because farms are unproductive. There have been great improvements in the field of farm productivity, but "agriculture is the one field in which all reductions in cost have been reflected in lower prices for the product." Meyers, *op. cit. supra*, p. 40.

<sup>83</sup>See address of Franklin D. Roosevelt, September 14, 1932, at Topeka, Kansas, stating that any program for the relief of agriculture must operate upon a cooperative basis and should enhance and strengthen the cooperative movement. *New York Times*, September 15, 1932. See also editorial in *New York Times*, December 25, 1944, in which it is pointed out that "with adequate education, good business organization, practical equipment, and a *chance to buy and sell through group action*, the family farm will still offer a good way of living to millions of Americans." (Emphasis supplied)

when the movement has passed the organizational and experimental stage. This attitude assumes that cooperatives are now so strong that they no longer need assistance. The facts do not appear to support this view. Any fair appraisal of the long-term situation must leave out of account the abnormal conditions arising out of the present war;<sup>84</sup> the situation of the farmers before the war and their probable condition after the war are the only bases upon which any policy judgment can be made. Only the most incorrigible optimist would suppose that the wartime agricultural situation can exist for long after the war.<sup>85</sup> It would be a reckless act to postulate any long term policy upon such a view and it must be assumed that the agricultural industry will suffer some setback at the end of the war or shortly thereafter. An attempt will, therefore, be made to determine whether the farmers were in such a position before the war that they no longer needed assistance in maintaining their cooperatives and, to the extent possible, whether they are likely to be in a similar situation after the war.

As pointed out above, the principal advantage of the tax exemption is that it assists cooperatives to build up their capital<sup>86</sup> if their members are willing to leave a portion of patronage dividends invested. The exemption is extended only to cooperatives substantially all of whose voting stock is owned by producers. Non-farmers may invest in their preferred stock or other non-voting stock, but this stock is not an attractive investment since dividends are fixed and since the stock gives no control. Cooperatives must therefore seek their capital principally from farmers unless they borrow it and commit themselves to interest payments. Farmers have, however, a very limited capacity for supplying

<sup>84</sup>The Department of Agriculture reports that purchases for the military, lend-lease and other exports have taken an increasing quantity of food commodities since 1939. In 1943 lend-lease and other exports took 10 per cent and military purchases took 11 per cent of food crops produced. *Agricultural Outlook Charts*, U. S. Department of Agriculture, November 1944, p. 13. It is obvious that this will not continue indefinitely after the end of the war. The Department does not think so and contemplates price declines in agricultural products after the war. See *Agricultural Outlook Charts*, pp. 86, 87, 88; also Press Release of speech by Robert H. Shields, Solicitor, War Food Administration and U. S. Department of Agriculture, "Maximum Prices with Respect to Agricultural Commodities," November 15, 1944.

<sup>85</sup>"In the field of agriculture a continued shortage of production and very high prices are to be expected for a few years after the end of the European war. But thereafter an overproduction crisis must be expected." Gunnar Myrdal, "Is American Business Deluding Itself?", *The Atlantic Monthly*, November 1944, pp. 51, 58.

<sup>86</sup>In this discussion it is assumed that cooperatives have income which could properly be taxed in much the same manner as other corporations.

capital at any one time.<sup>87</sup> Even in the boom years 1942, 1943, and 1944, the average annual net income per person engaged in agriculture was under \$1,500. In all previous years back to 1910 it was under \$1,000.<sup>88</sup> It does not seem probable that farm income will be as high after the war as at present. It would, therefore, appear that if cooperatives are to obtain working capital and capital needed for the construction or maintenance of their facilities, they will require help; agriculture is not yet in a position to sustain the cooperatives without some assistance.

The conditions which gave rise to the cooperative movement have by no means disappeared. In many areas cooperatives play no or little part and in most instances they represent a relatively small factor in the marketing operation.<sup>89</sup> There is still a large spread between the farm price and the retail price of foods.<sup>90</sup> In an analysis recently made by the Department of Agriculture<sup>91</sup> it was determined that in 1939 approximately 7.5 per cent of the consumer's dollar spent for cotton cloths went to cotton growers; 0.7 per cent for ginning and baling; and 2.1 per cent for merchandising services. The merchandising services involved effect the transfer of cotton from the gin to the textile mill. The remainder is accounted for by the processing and retailing costs. In the same

<sup>87</sup>See figures upon average farm incomes given above. It has been said that 3,000,000 farm families have inadequate incomes. Editorial, New York Times, December 25, 1944.

<sup>88</sup>1942—\$1,041; 1943—\$1,362; 1944 (estimated)—\$1,456. Agricultural Outlook Charts, p. 6.

<sup>89</sup>In this connection it may be pointed out that ordinarily cooperatives can fulfill the object of their existence, reducing marketing costs for the benefit of farmers and consumers, only if they are efficient. They can be efficient only if they handle a sufficient volume to obtain the benefits of mass or semi-mass methods and reduce the unitary overhead. M. C. Gay, *op. cit. supra*, p. 43.

<sup>90</sup>"The farmer's share of the consumer's dollar spent for farm food products was 52 cents in August 1944. This was close to the record high of 55 cents in April 1918. The farmer's share of retail cost to consumers is highest for livestock products and lowest for highly processed canned fruits and vegetables and bakery products. High farmers' shares for beef and butter were made possible (under price control) by Government payments to processors." Agricultural Outlook Charts, p. 18.

In 1933, farmers received 35 per cent of the retail value of 58 foods ordinarily purchased by typical working families; in 1938, 40 per cent; in 1939, 41 per cent; in 1940, 42 per cent; in 1941, 48 per cent. Agricultural Statistics 1942, *supra*, p. 656.

<sup>91</sup>To be published in a bulletin entitled "Marketing and Manufacturing Margins for Textiles." In 1933 the Senate Committee on Agriculture and Forestry said: "It is not generally understood how much the price of wheat could advance without greatly increasing the cost of bread to the consumer . . . In the case of cotton goods, consumers will be interested to learn what a small percentage of the retail price is represented by what the farmer gets." Senate Report No. 1251, 72nd Congress, 2d Session (1933) on H. R. 13991, p. 4.

study it was concluded that on the average, in the 1939 season, the farmer received 8.27 cents per pound for cotton which was sold to textile mills for 11.40 cents per pound. It is fairly clear that more efficient merchandising methods than those usually employed would reduce this spread.

Cooperatives have in some instances succeeded in reducing the spread between the farmer's price and the wholesale or retail price, but it is apparent that there is still room for a further reduction by the use of non-wasteful methods of merchandising. In fact, such a reduction is imperative if the purchasing power of farmers is to be maintained in a possible post-war decline of agricultural prices and of consumption of agricultural products. The need is for stronger, rather than weaker, cooperatives.

It is still true in many areas that the small farmer is at a great bargaining disadvantage in his local market. Shipments must be made in carload or truck load lots to be economically handled. The typical farmer does not have sufficient quantity available at any one time. Assembling, storing and grading the small lots must be undertaken by some agency. Where there is only a single or small number of buyers in a local area, "the advantage in bargaining power is heavily on the side of the buyer and against the farmer."<sup>92</sup> The buyers are ordinarily better informed concerning market conditions than are the farmers, and apparently are not always honest with them. Farmers frequently complain that local handlers make misrepresentations concerning the grades of produce offered, and concerning market prices and conditions. Farmers also complain that buyers sometimes act in concert to keep prices down.<sup>93</sup> Another example of the limitation among local buyers is found in the domination of some areas by canning companies. Frequently there is only one canning company in the area and rarely more than three or four to which the farmer can conveniently take his produce.<sup>94</sup> To insure themselves of adequate supplies some canning companies will contract for the entire output of surrounding farms or of certain acreages.<sup>95</sup> The farmers' need for competing agencies in areas where such conditions obtain is obvious.

There are many indications that the present trend is toward a more centralized and integrated marketing and processing of food products. Some of the processors are extending their operations

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<sup>92</sup>Meyers, op. cit. *supra*, p. 17.

<sup>93</sup>Meyers, op. cit. *supra*, p. 18.

<sup>94</sup>Meyers, op. cit. *supra*, p. 14.

<sup>95</sup>Meyers, op. cit. *supra*, p. 23.



back toward the farmer and processors themselves are organizing into larger and larger units.<sup>96</sup> With the improved mechanical agricultural equipment which is anticipated after the war, it is quite possible that large processors and marketing agencies will enter the farming field to a greater extent than before. If this trend continues, and it almost certainly will, the individual farmer, if he is to survive,<sup>97</sup> will be more in need than ever of cooperative group action to increase his bargaining power. While the cooperatives have grown in strength and power in recent years, it is fair to say that they have not kept pace with the increased centralization of control over marketing and processing simultaneously developed by the profit-making business organizations.<sup>98</sup>

The attack upon cooperatives which has been increasing during the past few years is principally centered upon cooperative manufacturing activities.<sup>99</sup> Many of these activities are undertaken on behalf of urban consumers as well as farmers. Where the cooperatives' stockholders (except preferred stockholders) are not all agricultural producers, the cooperative is not exempt under the statute.<sup>100</sup>

It is unfortunate that there has been some tendency in the public discussion of the tax status of cooperatives to assume that all cooperatives are tax exempt and to overlook the rather narrow language of the Internal Revenue Code. Although the tax treat-

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<sup>96</sup>Dr. F. V. Waugh, of the U. S. Department of Agriculture, has pointed out that during the last 50 years there has been a steady trend toward large scale organization and greater concentration of control in industries which process and control the distribution of agricultural products, such as corporate chain grocery stores, large meat packers and dairy corporations. Final Report and Recommendations of the T. N. E. C., *supra*, p. 388. Gay, *op. cit. supra*, pp. 7, 8, points out that terminal marketing agencies and fertilizer manufacturers exercise great control over the growing and distribution of potatoes in certain areas.

<sup>97</sup>Although at present less than 8 per cent of the agricultural output is accounted for by corporate farming (Final Report and Recommendations T. N. E. C., *supra*, p. 387), an increased number of farms are being industrialized (Final Report and Recommendations T. N. E. C., *supra*, p. 414). In certain areas, moreover, such as the Imperial Irrigation District of California, corporations own the greater part of the acreage. Many of these are shippers, handlers, or packers who have acquired the land to insure adequate sources of supply. Meyers, *op. cit. supra*, pp. 11, 13.

<sup>98</sup>See, e. g., A. C. Hoffman, Large-Scale Organization in the Food Industries, Monograph No. 35, Investigation of Concentration of Economic Power, Temporary National Economic Committee (1940), p. 25, with reference to the dairy industry, one of the most important fields of co-operative development in recent years.

<sup>99</sup>See, e. g., "Tax-Free Manufacturing Cooperative Corporations," and "Legal Tax Avoidance Threatens Private Enterprise," prepared by the Research Department of the National Tax Equality Association.

<sup>100</sup>*Co-operative Central Exchange v. Commissioner*, (1932) 27 B.T.A. 17.

ment of non-exempt cooperatives is an interesting subject, there is no attempt in this article to consider any cooperative organizations which do not fall within the rather restricted confines of the statutory exemption.

Even the increased activities of cooperatives in the field of purchasing supplies and equipment for farmers do not yet appear to have become sufficiently extensive to solve completely the farmers' problem of obtaining dependable supplies at reasonable prices. Many farmers still must buy many of their supplies and equipment at retail at local stores which have little competition because the area cannot support more.<sup>101</sup> The lack of competition between retailers has apparently encouraged manufacturers of farm machinery to attempt to force retailers to carry only their products and in any case a small country retailer cannot afford to carry many competing items.<sup>102</sup>

The prices paid by farmers as late as 1939 were still disproportionately high compared to those received by them.

*Indexes of Prices Paid by and Received by Farmers*  
(Base Year 1929)<sup>103</sup>

Year	Prices Paid by Farmers	Prices Received by Farmers	Ratio Prices Farmers Receive to Prices Farmers Pay
1929 .....	100	100	100
1930 .....	95	86	90
1931 .....	81	60	74
1932 .....	70	44	63
1933 .....	71	48	68
1934 .....	80	62	78
1935 .....	82	74	90
1936 .....	81	78	96
1937 .....	85	83	98
1938 .....	80	65	81
1939 .....	79	64	81

In the purchasing field the farmer will have to obtain his supplies and equipment more cheaply if post-war declining prices and

<sup>101</sup>Meyers, op. cit. *supra*, p. 30.

<sup>102</sup>Meyers, op. cit. *supra*, p. 31. "The mail-order house has for years been the chief source of economy for the farmer in making purchases . . . . The two chief disadvantages of mail-order buying are the necessary delay in receiving the goods and the inability of the mail-order house to give local repair service . . . . When we consider that each mail order is shipped individually at the highest freight rates per unit, the ability of the mail-order houses to undersell the local dealers must be considered a severe indictment of our whole wholesaling and retailing system." p. 32.

<sup>103</sup>Meyers, op. cit., *supra*, p. 39. It will be recalled that farm prices were depressed during the 1920's.

consumption are to be offset and his purchasing power maintained. In the post-war years, no more than in the 1930's, can there be a prosperous industrial development without maintaining the purchasing power of the farm population. While cooperative purchasing has been a growing activity in recent years, there are many farmers who are without cooperative facilities for purchasing many of their supplies and equipment. Caution must be exercised to avoid too great expectations of the benefits of cooperative purchasing, but it is known that it has in the past assisted the farmer in obtaining reliable supplies and equipment at reasonable prices. From that fact it may be properly deduced that a maintenance and extension of this service will contribute, to some extent, to the maintenance of agricultural purchasing power.

So important is it for the welfare of the whole nation that the purchasing power of the farm population be maintained at as high a level as possible,<sup>104</sup> that any activity which has a tendency in this direction should and must have the greatest encouragement. The exemption from income tax is probably not as powerful a support as some think it may be, but it does appear that it contributes materially to the welfare of the cooperatives and that the cooperatives are still in need of this assistance.

#### V. THE NATURE OF COOPERATIVES' INCOME, IF ANY

The assumption has been made *arguendo* that true cooperatives have taxable income in much the same manner as do ordinary business corporations. This assumption has been made to facilitate the

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<sup>104</sup>Some postwar plans for full employment contemplate the necessity of a national income of approximately 140 billion dollars if that goal is to be realized. See Postwar Federal Tax Plan for High Employment proposed by the Research Committee of the Committee for Economic Development (1944); Beardsley Ruml and H. Chr. Sonne, Fiscal and Monetary Policy, Planning Pamphlet No. 35, National Planning Association (1944). A National income of that amount or of any amount comparable to it will be impossible if farm income amounts to only 4,973 billion dollars as it was in 1938, the last year before the start of the war when national income amounted to approximately 64 billion dollars. In 1942 farm income amounted to 11,044 billion dollars. Statistical Abstract of the United States, 1943, U. S. Department of Commerce, Bureau of the Census, pp. 384, 385. It is estimated that in 1943 the national income was almost 148 billion dollars and that agricultural income 12.8 billion dollars. Any hope of maintaining a national income of approximately 140 billion dollars must contemplate agricultural income almost as large as that in 1942 when national income amounted to approximately 120 billion dollars. In a more recent bulletin, "National Budgets for Full Employment," the National Planning Association postulates as possible and desirable a national output of \$170 billion after relatively short time post-war adjustments have been made, although it recognizes that if certain conditions are met there may be full employment at lower figures. The \$170 billion figure assumes an agricultural output of \$12 billion.

discussion of what might be considered the economic merits of the question without confusing the issue by introducing the more abstract legal concept of income under the taxing system. In view of the fact that farmers' cooperatives and ordinary business organizations operate in wholly different ways, it is necessary to examine the validity of this assumption.

True farmers' cooperatives are owned and controlled by the producers of the farm products which are sold by the cooperatives, and by the farm consumers who utilize the supplies purchased by the cooperatives, or both. By their charters, by-laws, or by their marketing agreements they are required to return to the farmers the proceeds arising from the sale of farm products minus the cost of operation; they are also required to return to the farmer purchasing supplies the amount of the purchase price which is in excess of the cost of the cooperative plus expenses.<sup>105</sup> The members may agree that some of their patronage dividends or proceeds of sale may be retained by the cooperative permanently or for a period to build up capital.<sup>106</sup> The administrative practice has been to exclude patronage dividends from a cooperative organization's income even where the organization is not exempted from tax.<sup>107</sup> This is the correct view in the case of true cooperatives, not because these patronage dividends are deductible expenses, as is sometimes contended,<sup>108</sup> but because they are amounts to which the cooperative has no claim and takes as agent only.<sup>109</sup> The marketing cooperative is only a conduit through which flows income from the purchaser to the farmer. The conduit retains nothing but its own expenses, including depreciation reserves, and has, accordingly, no taxable income. Agencies through which pass income to

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<sup>105</sup>This may be done by selling at ordinary market prices and returning the excess in the form of patronage dividends at the end of the year, or the sale price may be fixed at cost plus estimated expenses. The first method is probably the more common, but in any event there is no difference in principle.

<sup>106</sup>Amounts thus retained are frequently put into preferred stock of the cooperative which pays a fixed dividend to the owner, or interest is paid upon the amount retained.

<sup>107</sup>*Co-operative Oil Association, Inc. v. Commissioner*, (C.C.A. 9th Cir. 1940) 115 F. 2d 666.

<sup>108</sup>*Co-operative Oil Association, Inc. v. Commissioner*, *supra*. Cf. the later decision by the same Court in *San Joaquin Valley Poultry Producers' Association v. Commissioner*, (C.C.A. 9th Cir. 1943) 136 F. 2d 382.

<sup>109</sup>*Greenwald v. United States*, (Ct. Cl. 1944) 57 F. Supp. 569; *United Cooperatives Inc. v. Commissioner*, (1944) 4 T. C. 93; *Midland Cooperative Wholesale*, (1939) 44 B. T. A. 824; cf. *North American Oil Consolidated v. Burnet*, (1932) 286 U. S. 417, 52 S. Ct. 613, 76 L. Ed. 1197, where the income was received under a claim of right.

which they have no right are not taxable upon that income.<sup>110</sup> Those amounts which are retained by the marketing cooperative to build up capital are properly to be regarded as either invested in or loaned to the cooperative by the farmer who would be entitled to receive this income<sup>111</sup> except for his agreement that he would loan or invest it in the cooperative. It would seem to follow that the amount of net income invested or loaned is taxable income to the farmer just as are the proceeds which he actually receives, since these amounts are not income to the cooperative.<sup>112</sup>

The strict application of the constructive receipt approach by the Bureau of Internal Revenue will provide a marked deterrent to those who have attempted to abuse the exemption granted to true cooperatives and who have tried to take refuge from high corporate taxes behind a cooperative facade. If the undistributed cooperative net income is included in its members' or stockholders' incomes those profit-making corporations or individuals who have

<sup>110</sup>*Bartlett, et al v. Commissioner*, (1933) 28 B. T. A. 285, *aff'd* (C.C.A. 4th Cir., 1934) 71 F. 2d 601 and 598; *Diescher v. Commissioner*, (1937) 36 B. T. A. 732, 745, *aff'd* (C.C.A. 3d Cir. 1940) 110 F. 2d 90.

<sup>111</sup>This income, it should be noted, is not gross receipts, but gross receipts minus cost of operation, which should include a reserve for depreciation of assets. If the cooperative maintains no depreciation reserve but pays out that amount to patrons, there is in part a return of capital. Presumably a depreciation deduction could be taken, but in any well managed cooperative reserves for depreciation would be set up and maintained. In such a case the patron would receive or have credited to him only the gross receipts minus expenses, depreciation, and other costs.

<sup>112</sup>*San Joaquin Valley Poultry Producers' Ass'n. v. Commissioner*, (C.C.A. 9th Cir. 1943) 136 F. 2d 382. The Commissioner has ruled that there is constructive receipt by patrons of the portion of patronage dividends retained by cooperatives when the patron receives a certificate of indebtedness of shares of stock for the retained amount irrespective of whether or not the certificate share has any ascertainable market value. Ruling dated November 23, 1943, addressed to the National Council of Farmers' Cooperatives. It would seem to follow that any portion of retained patronage dividends which are credited to or allocable to a patron's account would result in constructive receipt of income by the patron. This approach appears to be sound, and is based upon the doctrine of anticipatory assignment. This doctrine is that a person realizes taxable income where he is entitled to receive income, but directs that this income be paid to someone else. It is then, the courts say, just as if he had received the income and himself paid it over to the actual recipient. See *Lucas v. Earl*, (1930) 281 U. S. 111, 50 S. Ct. 241, 74 L. Ed. 731; *Helvering v. Horst*, (1940) 311 U. S. 112, 61 S. Ct. 144, 85 L. Ed. 75; *Helvering v. Eubank*, (1940) 311 U. S. 122, 61 S. Ct. 149, 85 L. Ed. 81; *Harrison v. Schaffner* (1941) 312 U. S. 579, 61 S. Ct. 759, 85 L. Ed. 1055; *United States v. Joliet & Chicago Railroad Company*, (1942) 315 U. S. 44, 62 S. Ct. 442, 86 L. Ed. 658. Any other view would tend to ignore the annual accounting basis which is the fundamental plan of our income tax laws. *Burnet v. Sanford & Brooks Co.*, (1931) 282 U. S. 359, 51 S. Ct. 150, 75 L. Ed. 383. If undistributed income (in excess of costs) is not taxable to the cooperative and is not taxed to the patron until actual distribution is made, it will present a possibility of offsetting a high income in one year against losses in subsequent years.

put on a cooperative false face for tax avoidance purposes will discover that their disguise has netted them much less than they had hoped and, in many cases, nothing. Furthermore, it will increase the interest of stockholders and patrons in seeing to it that wise capital investments are made.

Accordingly, in terms of the tax law, a true marketing cooperative which returns all the proceeds of sale (minus costs and expenses) to its patrons, except those proceeds which are invested or loaned to it by patrons,<sup>113</sup> has no net taxable income within the ordinary meaning of that term.<sup>114</sup> Where an organization is not a true cooperative and its members profit from transactions with non-members, the exemption does not apply because the situation is there more akin to that of a corporation carrying on business for profit and realizing taxable income in the process.<sup>115</sup>

In respect of the purchasing activities of cooperatives, the basic reasoning is somewhat different. Like the marketing cooperative, it may be argued that the cooperative itself realizes no income because it has no claim to any funds passing through its hands. It must repay to its members any amounts in excess of its costs, except for any amount which the members may decide to invest in or loan to the cooperative. The savings made by a purchasing cooperative for its patrons, which may be passed on to them either in the form of reduced prices or patronage dividends—which amount to the same thing—are not considered income to the patrons. This is because bargain purchases are not ordinarily considered to result in taxable income.<sup>116</sup> The farmer's taxable

<sup>113</sup>Amounts received as loans or as contributions to capital are, of course, not considered income.

<sup>114</sup>It will be recalled that the first specific exemption of farmers non-profit marketing associations appeared in the Revenue Act of 1916. The Ways and Means Committee in its report upon this act (H.R. Report No. 922, 64th Congress, 1st Session, 1916, p. 4, 1939-1 Pt. 2, Cum. Bull. p. 22, 24) stated that exemption was specifically extended to those organizations and others "in view of the fact that the experience of the Treasury Department has been that the securing of returns from them has been a source of expense and annoyance and has resulted in the collection of either no tax or an amount which is practically negligible."

<sup>115</sup>*Fruit Growers' Supply Co. v. Commissioner*, (C.C.A. 9th Cir., 1932) 56 F. (2d) 90; *Farmers' Union Cooperative Co. v. Commissioner*, (C.C.A. 8th Cir., 1937) 90 F. (2d) 488; *The Farmers' Union Cooperative Supply Co. v. United States*, (Ct. Cl., 1938) 25 F. Supp. 93.

<sup>116</sup>*Rose v. Trust Co. of Georgia*, (C.C.A. 5th Cir. 1928) 28 F. (2d) 767. Bargain purchases may result in taxable income when they are actually a method of paying compensation or of distributing corporate assets or income; *Commissioner v. Smith*, (1945) ..... U. S. ...., 65 S. Ct. 591, 89 L. Ed. ....; rehearing denied, (1945) ..... U. S. ...., 65 S. Ct. 891, 89 L. Ed. ....; *Palmer v. Commissioner*, (1937) 302 U. S. 63, 58 S. Ct. 67, 82 L. Ed. 50; *Choate v. Commissioner*, (C.C.A. 2d Cir.

income is increased, however, as a result of the cooperative activity because his cost of production is lowered by his smaller outlay for supplies.

The only funds passing through the hands of the cooperatives which could presently be properly considered to be their taxable net income, in the absence of statutory exemption, are the amounts retained by the cooperatives to pay interest on borrowed funds or fixed dividends generally payable upon preferred stock.<sup>117</sup> The amount used to pay interest would be offset by the deduction for the interest paid. There would, therefore, be no tax revenue from this source. The same reasoning would not apply to the payment of fixed dividends generally payable upon preferred stock. In 1936 the preferred stock outstanding in farmers' cooperatives amounted to \$22,760,000 and their indebtedness stood at \$35,740,000.<sup>118</sup> No exact information concerning the average fixed dividends payable upon preferred stock appears to be available, but it is fair to assume that the dividend rate fixed is generally low. Assuming a rate of 4 per cent,<sup>119</sup> the dividends paid all over the country would amount to only \$910,400, which, if taxed, would produce very little revenue.<sup>120</sup> With full recognition of the present necessity for high government revenue, the small return from subjecting these sums to income tax would not justify the removal of the exemption, either from the viewpoint of the social values involved or from the practical view that the taxes collected might be far in excess of the administrative costs of collection.

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1942) 129 F. (2d) 684; *Eastern Carbon Black Co. v. Brast*, (C.C.A. 4th Cir. 1939) 104 F. (2d) 460; *Erskine v. Commissioner*, (1932) 26 B. T. A. 147. These situations are not present in the case of purchasing cooperatives because the sale is not between the patrons and the cooperative, but rather the sale is between the patron and the seller of supplies with the cooperative acting as agent for its patrons. There is no assignment of income by the cooperative to the patron because the cooperative has no right under the agreed upon arrangements to receive any income in excess of its expenses. Any other sums it receives as loans or capital investments.

<sup>117</sup>If it were so considered, it would not be taxable income to the farmers upon the constructive receipt basis.

<sup>118</sup>A Statistical Handbook of Farmers' Cooperatives, Farm Credit Administration, Bulletin No. 26, (1938) p. 161. No later figures appear to be available upon preferred stock outstanding.

<sup>119</sup>This appears to be a fair assumption because cooperatives can borrow funds for less from the Bank for Cooperatives. A Statistical Handbook, *supra*, p. 193. There would be no reason why they should pay much more to preferred stockholders.

<sup>120</sup>At a corporate rate of 40 per cent, the revenue would amount only to \$364,160. This rate is employed because it appears unlikely that the high excess profits tax upon corporations will long survive the end of the war. Roy Blough, Assistant to the Secretary of the Treasury, in a speech delivered in Chapel Hill, North Carolina, on November 17, 1944, stated that the excess profits tax had "a short life expectancy."

The difference between the situation of the cooperatives and that of the ordinary business corporation is apparent. The true cooperatives at no time have any right to the funds passing through their hands (except as to sums payable as fixed dividends as opposed to patronage dividends) whereas an ordinary corporation has the right to retain the profits accruing from its operations and to use them for its own purposes. It is true that these profits may be distributed to shareholders when so determined by the Board of Directors, but the shareholders have no predetermined right to receive dividends. Moreover, they are not ordinarily consumers of the goods and services provided by the corporation and, in any event, the distribution is made in accordance with the capital investment of shareholders, not in accordance with their participation in company business. It has frequently been pointed out that if non-cooperative agencies were willing to render services at the cost to them, they would not be subject to income tax.

Perhaps cooperative activity could be analogized to the not uncommon situation existing where the selling or purchasing functions of an incorporated business are carried on by a subsidiary corporation. In such a case the subsidiary may charge its parent only the cost of its services and pass on to the parent through lowered charges or prices any savings which efficient operation may have allowed it to achieve. The subsidiary pays no income tax because it has no income; the subsidiary's owner has a higher income than, and a competitive advantage over, those who pay a middleman's profit. Middlemen, of course, are deprived of their profits on the activities carried on by the subsidiary. However, except perhaps where income tax avoidance is a motive, it has never been suggested that a subsidiary operating in this manner be subjected to an income tax even though there is no net income. To tax the subsidiary would be contrary to the whole theory and practice of the revenue laws.

If the basic principles of our revenue laws were to be completely altered it might be possible to devise a system of taxing organizations which have little or no net taxable income under present concepts. A gross receipts tax might be imposed upon cooperatives, marketing or purchasing subsidiaries, and upon other businesses whose expenses equal their intake. Apart from possible constitutional objections, the arbitrary and discriminatory characteristics of gross receipts tax are such that it would appeal to very few. It would be in direct derogation to the fundamental concept of the income tax, ability to pay. Any attempt to subject true



cooperatives to income tax, if any substantial revenue were to be produced, would have to disregard completely the cooperative theory, take some form of gross receipts tax, or tax as cooperatives' "income" something which is outside the realm of our traditional understanding of "income." A tax might take the form of removing the exemption and providing that cooperatives could not deduct their business expenses. Unless others were also denied the right of deduction or were similarly treated, such a provision would be so discriminatory as possibly to bring into question its validity under the Fifth Amendment to the Constitution.

If the theory of cooperatives were to be completely disregarded, it might be possible to characterize patronage dividends either paid or withheld as income of the cooperative and to subject them to tax in the hands of the cooperatives. Such a view would, of course, do great violence to the basic principles upon which cooperatives are organized. The sole object of their existence is to act as agent for their patron-owners in selling and purchasing. The fact that the owners of cooperatives are substantially identical to the patrons, and the fact that non-owner patrons are treated in the same manner as owner-patrons, distinguish true cooperatives from other forms of business enterprises operated for profit by individuals, associations or corporations. Any attempt to subject to tax in the hands of the cooperatives the sums payable as patronage dividends would ignore this basic legal relationship between the cooperative and its owners, a relationship which, incidentally, has been widely recognized and implemented by state laws. It is well recognized that tax laws, to be administratively practical, and to avoid being oppressively burdensome, must be related to actual business practices and legal relationships.<sup>121</sup> A disregard of this principle in the case of cooperatives would probably have the effect of destroying the movement almost entirely and certainly would result in a weakening of the farmers' cooperatives. While there may be those who would consider this result desirable, the better view would seem to be that it would have an unfortunate effect upon the entire national economy.

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<sup>121</sup>When legal relationships are utterly disregarded, as for example, by an attempt to tax A upon income which under our laws would be regarded as belonging to B, the attempt may run afoul of the Fifth Amendment to the Federal Constitution. *Hooper v. Tax Commission of Wisconsin*, (1931) 284 U. S. 206, 52 S. Ct. 120, 76 L. Ed. 248. The view is not taken that an attempt to tax cooperatives in the manner suggested would be unconstitutional, but it would involve a very substantial deviation from present practice.

## CONCLUSION

In summary it is concluded that the farmers' cooperative movement came into existence in response to an important social and economic need; that it has partially met this need; but that the conditions from which cooperation arose still exist to a considerable extent and are likely to continue for some time. At least until the farmers' cooperative movement is much stronger than it is at present, it would appear to be sound public policy to continue to give to cooperatives such assistance as they have in the past received from income tax exemption.

Upon examination and analysis of the facts it also appears that tax exemption gives farmers' cooperatives less competitive advantage than is sometimes supposed; and that such advantage as it may give in the direction of assisting cooperatives to raise capital does not suffice to place them in as favorable a position to raise capital as are ordinary profit-making corporations. Finally, if the exemption were removed, the Government would obtain very little revenue from cooperatives unless traditional concepts of income were radically changed or existing legal relationships were utterly ignored. Any such change, unless it was highly discriminatory against cooperatives, would bear heavily and most inequitably upon many other organizations and business enterprises. The continuation of the exemption of cooperatives appears to be desirable and necessary in the interest of maintaining a prosperous and independent agricultural industry.